STANDARD COSTING

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Standard costing is most suited to an organisation where there are common or repetitive operations, for example in manufacturing companies. Standard costs are "*predetermined costs; they are target costs that should be incurred under efficient operating conditions*" (Drury, 2015:406). Standard costs are calculated on a per unit basis and may be used to develop budgets for different levels of activity. This article first outlines the different types of standard costs and how they are established. Next, the main purposes and limitations of standard costs are presented. The article concludes by describing how a standard costing system operates.

Figure 1 shows an overview of how standard costs are developed and used.

DIFFERENT TYPES OF STANDARD COSTS

There are three main categories of standard costs, basic standard costs, ideal standard costs and currently attainable standard costs.

Basic standard costs: these are standard costs that do not change over many years. The advantage of this type of standard cost is that it provides a base for comparison with actual cost over a period of years. However, changes may occur in prices; methods of production; or other factors so that basic standard costs are no longer useful as they do not represent current costs; they do not accurately represent what the organisation expects to achieve now.

Ideal standard costs: these standard costs represent perfect performance. They assume 100% efficiency, that there are no losses or idle time. They represent the minimum costs that are possible under the most efficient operating conditions. Ideal standard costs are not generally used in practice as they are likely to have a demotivational effect on staff. However, the company may set ideal standard costs as goals to aim for rather than performance that must be attained. By doing this it is possible that the company's performance level will improve over time and it will become more efficient and more competitive.

Currently attainable standard costs: these are standard costs that should be attainable under efficient operating conditions. These standards incorporate the possibility of machine breakdowns, normal wastage and lost time. Currently attainable standards should be tough but realistic. They should be tough so that staff will have to work hard to achieve the standards but they also must be realistic because if not staff will not be motivated to work hard. Currently attainable standard costs are the most suitable for companies to use. They provide information for planning and control purposes.

APPROACHES TO ESTABLISHING STANDARD COSTS

In general there are two approaches that may be used when establishing standard costs, i) historical records and ii) engineering studies.

Historical records: with this approach past records of the company's operations, purchase and use of materials and labour serve as a basis for establishing current standards. This approach is often used in practice.

The advantages of this approach are that it is relatively inexpensive; it uses actual company data to compute standard costs and provides a reference for future improvement.

The disadvantages of using past historical records are that there is the possibility that past inefficiencies will be incorporated in the standard costs; if the production process changes the historical data will be irrelevant and if the company introduces new products then using this approach to develop cost standards will not be possible.

Engineering studies: this approach requires a detailed study of each production operation to be conducted so that standard costs are based on observed recorded activity. Engineering studies may also require input from operating personnel to provide estimates about future activities and consumption levels.

The advantages of this approach are that it is future oriented; it aims to ensure that past inefficiencies are not incorporated in standard costs. In addition, this approach facilitates allowance for expected changes such as alterations to the production process or product redesign.

The disadvantages of this approach are that it is time consuming and expensive to employ. Engineering studies require a comprehensive team approach combining input from production, human resources, sales and finance staff. While such an approach may improve the reliability of cost estimates and increase commitment and motivation, there is the possibility of data bias to set easier to achieve standard costs.

PURPOSES OF STANDARD COSTING

A standard costing system:

- Assists in the preparation of budgets and evaluation of managerial performance.
- Serves as a control mechanism by highlighting activities which deviate from plan.
- Provides a means of motivating individuals to achieve predetermined targets.
- Facilitates the accumulation of product costs for inventory valuation purposes.
- Provides an estimate of future costs that may be used for decision making purposes.

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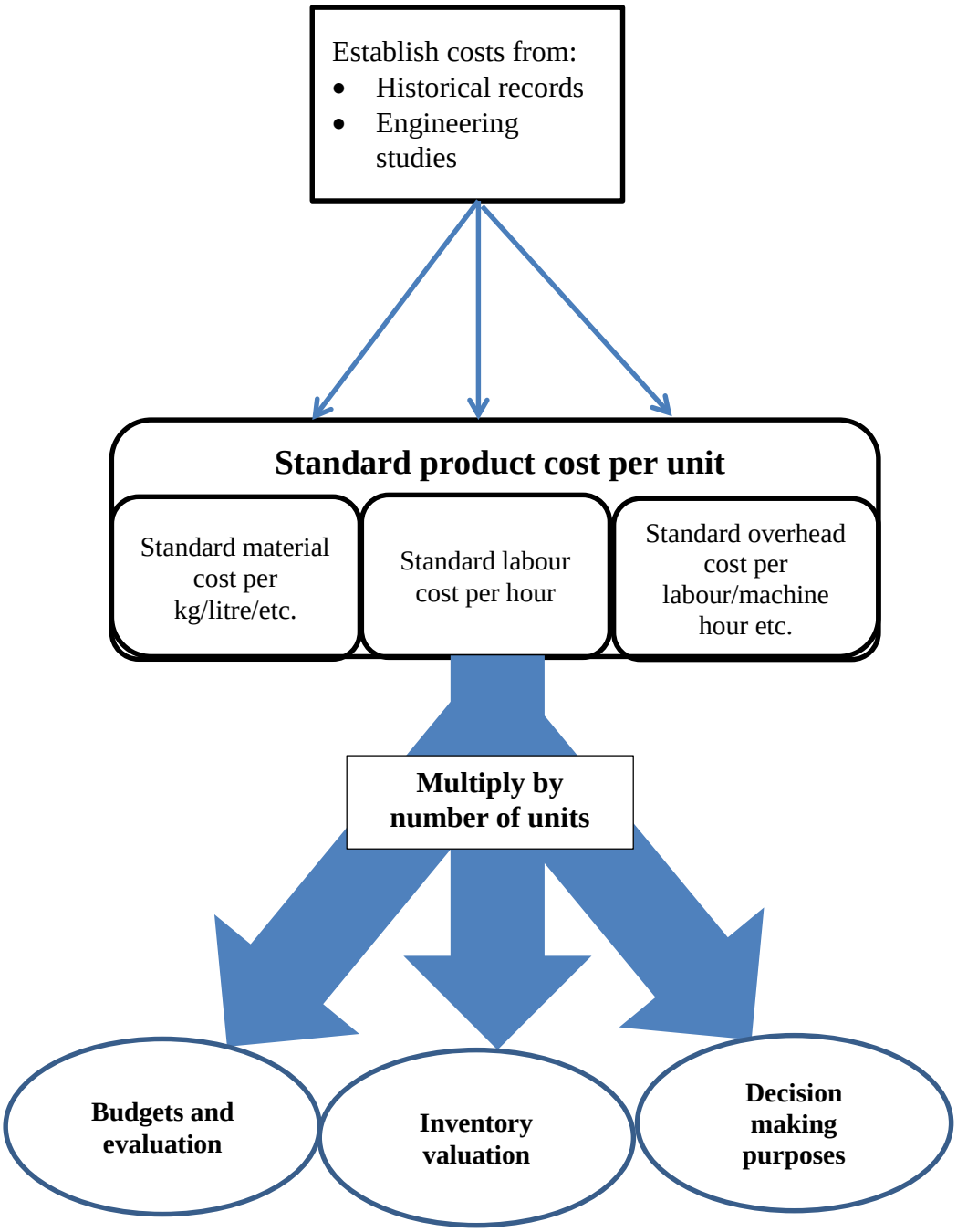
LIMITATIONS OF STANDARD COSTING.

- Standard costing was developed when the business environment and operating conditions were more stable. The modern business environment is much more dynamic suggesting that standard costing may be less applicable.

- In the past it was considered satisfactory for performance to reach predetermined standard levels. This is not the case in today's challenging business environment; constant performance improvement is required to remain competitive.
- Past production processes were much more labour intensive and consequently labour standards and variances were in greater focus. However, significant changes to production processes have increased automation so that in many cases labour standards and variances are now less relevant.

Figure 1 – Overview of development and use of standard costs



HOW A STANDARD COSTING SYSTEM OPERATES

There are five steps involved in a standard costing system as follows:

1. Set standard costs

Standard costs should be established for each operation or aspect of production. The standard cost of a product is an accumulation of the standard costs of the operations necessary to make the product. As noted above, standard costs may be set using past historical data or using data from engineering studies.

2. Record actual results

The actual costs involved in the particular operation or activity should be carefully recorded so that they may be compared with their corresponding standard costs.

3. Compare results and calculate variances

Total actual costs should be compared with total standard costs for each operation and the differences between them are called variances. These variances may be analysed into those arising as a result of price differences and those arising from usage or efficiency differences.

4. Investigation of variances and corrective action

Variances arising may be investigated to ascertain their cause so that corrective action may be taken. For example, if investigation of a materials variance indicated that there was excessive usage of material, the responsible manager should then try to establish the reasons for the problem. This should then result in remedial action being taken to ensure that the problem did not recur.

5. Monitoring of standards

As a result of investigating variances, the responsible manager may find that the original standard was too stringent, in which case the standard should be adjusted to reflect a more attainable level. Standard costs should be monitored on an ongoing basis to ensure that they reflect currently attainable standards.

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